On Predation and Venture Capital-Funded Free Goods and Services

Comments by Anant Raut[1]

In this paper, I show that free goods and services in the tech sector underwritten by loss shifting to venture capital investors can be a form of predatory pricing, and that recapitalization at a higher valuation or an increase in stock price is a form of recoupment that would satisfy the traditional three-prong test.

What is good for investors is frequently at odds with what is good for consumers. Investors often prefer markets with few players, high barriers to entry, customer lock-in, and stable or growing prices with big margins. Consumers benefit the most in markets with excess capacity, overbuilding, price wars, expansion for the sake of expansion, introductory offers, deals, and discounts. Consumers want ruinous competition.

What should be great for consumers, then, are the free or heavily discounted goods and services that we see from many tech startups. Under traditional antitrust metrics, such products are a net benefit for consumers – there is output where there previously was none, and the price is zero or extremely low. But this betrays an incomplete and incorrect view of what puts these “free” or heavily discounted goods and services into the market in the first place. The cost for providing many of these free goods and services is footed by venture capital, which ultimately expects a return on its investment.

Loss shifting to venture capital investors allows goods and services to be sold below cost. Per the FTC’s own website, it’s not illegal for a company to offer services below cost (to gain customers or market share), nor is it illegal for a company to offer services below a rival’s cost (unless it crosses over into predation). Moreover, it’s also permissible to price below cost in order to match or beat prices from a lower-price competitor. But consumers can be harmed when below cost pricing crosses over into predatory pricing.

Free in particular represents a blind spot for traditional antitrust analysis. When goods and services are being offered for free, it’s tempting to look past them, thinking, where’s the harm to consumers? A second reason this phenomenon has escaped scrutiny from antitrust enforcers is that these companies frequently have competitors also loss shifting to their venture capital investors, so it’s easy (albeit wrong) to think of them as existing in a kind of equilibrium. But this is a dangerously loose way to justify market-distorting competition that may ultimately be injurious to consumers. Consumers are worse off long term if these companies end up driving out smaller and local competitors operating under a traditional profit-maximization strategy. Startups who are encouraged by investors and rewarded by the market to grow as quickly as possible and worry about monetizing later can drive out local and nascent competition in new and existing markets by ”flooding the zone” with unsustainably low prices that regular profit-seeking businesses can’t match.

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Bloomberg BusinessWeek chronicled this strategy in China. There, startups bankrolled by big-pocketed investors offered consumers a wealth of new free or low-cost goods and services, with a strategy of growth over profitability:

> "A lot of VCs believed in the formula that if you have tremendous user growth, there will be some way to convert that into profitability. If you can just get 1 million, or 3 million users, then the rest will work itself out."[2]
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> "All were backed by at least one of the country's internet troika of Baidu-Alibaba-Tencent, who as investors were said to have orchestrated the mergers to staunch losses. Uber and Didi alone are estimated to have spent billions trying to undercut each other."[3]

But the only path to profitability depended upon driving competitors from the market.[4]

> "'It's not that they want to feed the Chinese consumer and give them goodies, **it's that they thought the end result would be a monopoly that is worth a lot of money**,' said Richard Lim, a managing partner at GSR Ventures and an early Didi investor. 'So the end justified the means.'"[5] (emphasis added)

Rethinking our understanding of predatory pricing

It is generally not easy to bring a predatory pricing case under existing antitrust law. There's no statutory framework, or agency guidance ala the Horizontal Merger Guidelines. Rather, multiple jurisdictions have adopted the framework spelled out in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*[6], which requires below-cost pricing, sustained for a period of time, with the prospect of recoupment once competition has been driven from the market and the predator has gained substantial market power.

The example above could be investigated under the traditional *Brooke Group* test. The first criteria of *Brooke Group*, below cost pricing, is easily met by free goods and services, which are almost always by nature being offered below the marginal cost of production, and the length of time is measurable. And in instances like the one cited above, recoupment can be shown by the increase in prices after the price constraining competitor was driven from the market.

Harm to competition from predatory loss shifting can also occur even when the predatory company takes no immediate steps to raise prices. Under *Brooke Group*, that might lead to a false conclusion that no predation has occurred because in the absence of a price increase, that there has been no recoupment. But this is a buggy whip understanding of competition in the tech space. The recoupment

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[2] Larson, C. and D. Ramli, "The Twilight of China's Online Consumer Paradise," *Bloomberg BusinessWeek* (August 11, 2016).
[3] *Ibid.*
[4] In China's case, the article faults bad merger policy for permitting massive "merger[s] intended to end internecine subsidy wars." But the intent was to drive price-constraining competitors from the market, after which consolidation created "dominant players with unrivalled pricing power [which meant that] outsized discounts [were] no longer needed." At that point, the winners were able to raise prices, which was always the endgame for investors.
[5] *Ibid.*
[6] 509 U.S. 209 (1993)

prong may be satisfied by taking a more expansive and realistic view of why sustained long-term losses are an economically rational decision. There are other rational outcomes that don't require profitability. Firms can be rewarded with higher valuation simply for growth. *Recapitalizing at a higher valuation is a form of recoupment. For post-IPO companies, a sustained increase in stock price is a form of recoupment.* Even without turning a profit, the value of a company can continue to increase via loss-shifted expansion.

Conclusion

Consumers are harmed by the loss of competition. And it is incorrect to defend anticompetitive behavior as a false binary choice between having these goods and services with the potential for predatory behavior, or not having them at all. Low prices for consumer has never been a defense against illegal anticompetitive activity.

Venture capital-funded free goods and services can and should be subject to predatory pricing analysis, which can be done without modifying the *Brooke Group* test. In some instances, it may require a rethinking of how we define "recoupment."

From a policy perspective, the agencies should evaluate venture capital-funded free goods and services, particularly in the tech space, for potential predatory pricing. The agencies may want to consider publishing guidelines for predatory behavior that take into account alternate economically rational forms of recoupment. Recoupment does not require short-term profit recoupment. Recapitalization at a higher valuation may itself constitute recoupment, as would a sustained increase in stock price, when profitability-as-afterthought is rewarded as a rational business strategy.